86-490

Supreme Court, U.S.
FILED
SEP 25 1986
JOSEPH F. SPANIOL, JR.
CLERK

No.

In the Supreme Court of the United States

OCTOBER TERM, 1986

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ILLINOIS CEREAL MILLS, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Assistant Attorney General

ALBERT G. LAUBER, JR.
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

JONATHAN S. COHEN
WILLIAM A. WHITLEDGE
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

20pp

QUESTION PRESENTED

Whether the fact that 95% of the electrical power in a new factory is used to operate machinery means that 95% of the cost of installation of the factory's electrical system qualifies for the investment tax credit, even though Section 48(a)(1)(B) of the Internal Revenue Code expressly provides that "structural components" of a building do not qualify for the credit.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

In the Supreme Court of the United States

OCTOBER TERM, 1986

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ILLINOIS CEREAL MILLS, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 789 F.2d 1234. The opinion of the Tax Court (Pet. App. 25a-106a) is unofficially reported at 46 T.C.M. (CCH) 1001.

JURISDICTION

The judgment of the court of appeals (Pet. App. 24a) was entered on April 28, 1986. On July 17,

1986, Justice Stevens extended the time within which to petition for a writ of certiorari to and including September 25, 1986. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of Sections 38 and 46 of the Internal Revenue Code of 1954 (26 U.S.C.) and of Section 1.48-1 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) are set out in a statutory appendix (App. 109a-112a).

STATEMENT

1. Respondent conducts a corn milling business in Paris, Illinois. During its fiscal year ending September 30, 1976, respondent completed construction of, and placed in service, a new specialty mill. The structure was designed by one of respondent's employees and was constructed solely for the purpose of housing the machinery and equipment necessary to conduct its specialty food processing operations. Pet. App. 2a, 55a-61a.

The focus in this case is on the electrical distribution system that provides power to respondent's specialty mill. The system is contained in a room approximately 60 feet by 20 feet, constructed of lightweight concrete blocks and located on the second floor of the mill. Power is delivered to the room from the electric utility company and leaves the room through wiring encased in conduit that passes through holes in the walls and ceiling (Tr. 210). The electrical distribution system contained in the electrical room consists of standard circuit breakers, transformers, power panels, switchboards, motor control centers, and associated wiring (Pet. App. 2a).

The basic function of the distribution system is to break down the high-voltage power delivered by the electric company into voltages usable in the mill (Pet. App. 2a). The power company supplies electricity to the factory at 4,160 volts. The power first passes through one of seven circuit breakers, and then into a transformer that reduces the 4,160 volts to 480 volts. The 480-volt power passes through another circuit breaker and into a power panel or control center panel. Three of the seven panels supply power at 480 volts to the operating equipment in the mill. Some of the 480-volt power supplied to the other four power panels is delivered to transformers that reduce the voltage from 480 to 120 and pass it to another set of breaker panels. Those panels are used to supply power for lighting and other general needs of the building. The remainder of the power supplied to the original four panels is delivered to the control centers at 480 volts for use in operating the mill equipment. Tr. 219-220; Exh. 33-AG.

2. On its income tax return for 1976, respondent claimed an investment tax credit, as provided in Section 38 of the Code,[1] based on the construction of the specialty mill.[2] Respondent treated the entire mill as "qualifying property" and hence used the total cost

---

[1] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended (the Code or I.R.C.).

[2] Section 38 allows a taxpayer to take an investment tax credit, which is defined by reference to other sections of the Code. Section 46(a) provides in detail for computation of the credit; the "regular percentage" is 10% of the qualified investment. Section 48(a) of the Code defines "section 38 property," which constitutes the property that qualifies for the investment tax credit.

of the mill as the basis for the computation of the credit. Property qualifying for the credit, generally termed "section 38 property," is defined to include "tangible personal property" and "other tangible property." I.R.C. § 48(a). The Code specifically provides, however, that "a building and its structural components" do not qualify for the credit. I.R.C. § 48(a)(1)(B). Applying this statutory definition, the Commissioner determined that $548,588 of the total cost of the mill ($1,843,644) was not eligible for the credit because it was attributable to the cost of the building and its structural components. With reference to the electrical distribution system in particular, the Commissioner determined that $80,106 of its total cost ($178,013) was attributable to the building as a whole and hence did not qualify for the credit because it was a "structural component" of the building. Pet. App. 58a n.16. In his statutory notice of deficiency, the Commissioner disallowed the claimed credit with respect to the $548,588 of nonqualifying property (*id.* at 61a).

The Tax Court sustained the Commissioner's determination that the specialty mill was a "building" within the meaning of Section 48(a) and hence rejected respondent's contention that the entire cost of the mill qualified for the credit (Pet. App. 88a-102a). The court also held that a portion of the electrical distribution system was a "structural component" of the building and that part of its cost did not qualify for the credit. The Tax Court disagreed, however, with the Commissioner's determination as to what portion of the cost of the electrical distribution system should be attributed to the building as a whole (which portion would not qualify for the credit) and what portion should be attributed to the machinery

and equipment contained within the building (which portion would so qualify). See I.R.C. § 48(a)(1)(B) (providing that "other tangible property," including machinery used in manufacturing operations, qualifies for the credit). Based on evidence in the record that "approximately 95 percent of the actual electrical load at the specialty mill" was used in operating the machinery and equipment, and that only 5% of the load was used for lighting, air conditioning, and general operation or maintenance of the building, the court concluded that 95% of the cost of the electrical system qualified for the investment tax credit. See *id.* at 58a-59a. The Tax Court relied in this regard (*id.* at 102a-103a) on its prior decision in *Scott Paper Co.* v. *Commissioner*, 74 T.C. 137 (1980), which had approved such an allocation based on percentage of usage.[3] The Tax Court noted its disagreement with *A.C. Monk & Co.* v. *United States*, 686 F.2d 1058 (4th Cir. 1982), which "ha[d] rejected [the] allocation approach" adopted in *Scott Paper*. Pet. App. 102a-103a & n.29.[4]

3. The Commissioner appealed on the question of the treatment of the electrical system cost, and the court of appeals affirmed (Pet. App. 1a-23a). The court stated that the question whether a particular item of property should be considered a "structural component" turned on the extent to which it was "re-

[3] Although the opinion in *Scott Paper* was issued in 1980, several other questions in the case subsequently were ordered retried. The Tax Court has not yet entered a final decision in *Scott Paper* for purposes of appeal. See I.R.C. § 7483.

[4] The Tax Court decided several other issues in a lengthy opinion (Pet. App. 25a-106a), but the only issue litigated on appeal was the extent to which the cost of the electrical system qualified for the investment tax credit.

late[d] to building operation and maintenance" (*id.* at 10a). Applying this principle to the facts of this case, the court pointed out that 95% of the "load" passing through respondent's electrical distribution system is used to power respondent's machines and equipment, and the court accordingly concluded that 95% of the cost of the electrical system should not be characterized as the cost of a "structural component" of the building (*id.* at 12a-14a).

The court relied heavily on the Tax Court's prior decision in *Scott Paper*, which it characterized as "squarely on point" (Pet. App. 14a). The court explicitly stated (*id.* at 15a-19a, 22a-23a) that it disagreed with the Fourth Circuit's decision in *A.C. Monk*, which had rejected the Tax Court's view in *Scott Paper—i.e.*, both the general proposition that an electrical system that services machinery qualifies for the investment credit and the particular method of allocating the cost of an electrical system by measuring the percentage of overall "load" used to power such manufacturing equipment (686 F.2d at 1065). Instead, the Fourth Circuit in *A.C. Monk* had held that the cost of an electrical system could not qualify for the credit to the extent that the system is reasonably adaptable to other uses, as opposed to being "inextricably linked to the present specific machinery" that the taxpayer happens to be using at the time (*id.* at 1066). "[R]espectfully disagree[ing] with the Fourth Circuit's reasoning" in *A.C. Monk*, the Seventh Circuit in the instant case held that "the ninety-five percent of the system that powers [respondent's] machinery is 'other tangible property' that is not a building or structural component of a building under § 48(a)(1)(B)," and hence that it qualified for the investment tax credit (Pet. App. 23a).

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals establishes a clear conflict in the circuits on an important issue of federal taxation—the availability of the investment tax credit in connection with the electrical system of a new or improved factory. This question is a recurring one, for it can arise during the audit of any manufacturing company in virtually any industry. The court of appeals' erroneous decision, if allowed to stand, can be expected to have a substantial adverse effect on the Treasury because of the number of cases that involve this issue and the large sums of money that are ordinarily at stake in such cases. Accordingly, review by this Court is warranted to rectify the error of the court of appeals and to provide a rule of decision for this class of cases that can be applied uniformly nationwide.

1. The question here is whether, and to what extent, the electrical system of respondent's new factory building is "section 38 property" that qualifies for the investment credit. The statute defines "section 38 property" to exclude a "building and its structural components," but to include "tangible personal property" and "other tangible property," such as industrial machinery (I.R.C. § 48(a)). The court of appeals held that the cost of the installation of the factory's electrical distribution system must be allocated between "section 38 property" and "non-section 38 property" according to the ratio by which electrical usage is divided between the operation of machinery, on the one hand, and ordinary building maintenance, like lighting and climate control, on the other. As applied to the facts here, this interpretation resulted in qualification for the investment credit of 95% of the cost of the factory's wiring and other parts of its electrical system.

The court of appeals adopted this theory of allocation according to electrical usage from the Tax Court's decision in *Scott Paper Co.* v. *Commissioner*, 74 T.C. 137, 182-187 (1980). That case also involved an attempt to take the investment credit for the electrical system of a manufacturing facility. The Tax Court there stated that, under the definition of "section 38 property" contained in the Treasury Regulations, the "critical test" for all electrical improvements—indeed, for any improvements installed in a building that might appear to fall within the term "structural components"—was whether the improvements "relate to the overall operation and maintenance of a building" (74 T.C. at 183, citing Treas. Reg. § 1.48-1(e)). The Tax Court's view thus focuses on the ultimate destination or "end use" of the power that is supplied by the electric company. To the extent that a factory's electrical distribution system is used to serve general building purposes—such as lighting, heating, and air conditioning—the system would be a "structural component" of the building and would not qualify for the credit. On the other hand, to the extent that the distribution system is used to power machinery or other equipment used to produce the factory's product, the system on the Tax Court's view would be regarded as a functional part of that machinery or equipment and hence would qualify for the credit. (see 74 T.C. at 184). Because the electrical system of the facility involved in *Scott Paper* served both ends, the Tax Court allocated the cost of that system according to relative electrical usage, calculated from examination of electrical diagrams. The court then held that the percentage of cost not allocable to building maintenance qualified for the investment credit (*id.* at 185-186).

The Fourth Circuit in *A.C. Monk & Co.* v. *United States*, 686 F.2d 1058 (1982), flatly rejected the allocation method adopted by the Tax Court in *Scott Paper*. The district court in *A.C. Monk*, in reliance on *Scott Paper*, had allocated the cost of the taxpayer's electrical system according to usage, reasoning that an electrical system should not be considered a structural component of a building to the extent it is actually used to power machinery. See 686 F.2d at 1065. The court of appeals reversed the district court on that point, holding that the question whether an electrical system serves machinery is irrelevant to whether the system constitutes a "structural component" (*id.* at 1065-1066). The court of appeals concluded that an allocation method based on the electricity's destination is analytically unsound because "it seems difficult to conceive of a single bus duct, transformer, or piece of wiring as being both a structural component and other property" (*id.* at 1065). Rather, the Fourth Circuit held, "the proper approach is * * * to determine whether the system has more general uses than simply operating specific items of machinery" (*ibid.*). "[I]f the wiring and other components of the electrical system could be adapted to other operations," the court held, those components must be treated as structural components of the building (*ibid.*). In particular, the Fourth Circuit explained that "an electrical system providing power to machinery is a structural component if the system can feasibly be adapted to uses other than the specific machine it was designed to serve" (*id.* at 1066). The court therefore reversed and remanded for the district court to consider whether the electrical systems in

question could be "reasonably adapted in the present building to more general uses" (*ibid.*).[5]

The instant case presented the Seventh Circuit with a factual situation essentially indistinguishable from that presented earlier to the Fourth Circuit and quite similar to that presented to the Tax Court—a factory electrical system consisting of standard electrical components but used primarily to power the factory's machinery. Faced with the conflicting methodologies adopted by the Tax Court and the Fourth Circuit to compute the investment tax credit in such circumstances, the Seventh Circuit decided to "adhere to *Scott Paper*" and to "disagree with the reasoning in *Monk*" (Pet. App. 15a). The court of appeals adopted as the basis for its analysis the Tax Court's view that the critical inquiry concerns the extent to which the electrical system "relates to building operation and maintenance" (*id.* at 10a). The court of appeals then found *Scott Paper* to be "squarely on point" (*id.* at 14a) and accordingly concluded that the cost of respondent's electrical system should be allocated between "section 38 property" and "non-section 38 property" by measuring the percentage of power used to operate the machinery, rather than used to perform building maintenance functions.

There can be little doubt that the Seventh Circuit's decision here squarely conflicts with the Fourth Circuit's decision in *A.C. Monk*. The Seventh Circuit held below that an electrical system qualifies for the

[5] On remand, the district court held that the taxpayer's electrical distribution system was a structural component because it was like most other electrical systems used in factories with heavy power demands and thus could be adapted and used by any subsequent occupant of the building. 577 F. Supp. 4 (E.D. N.C. 1983).

credit to the extent that it is used to power the factory's existing machinery, regardless of whether the system's components can be adapted to other uses (Pet. App. 17a). The Fourth Circuit has held, by contrast, that an electrical system cannot qualify for the credit merely because it serves the factory's existing machinery; rather, the system can qualify for the credit only if it is so "inextricably linked to the present, specific machinery" that it cannot "be reasonably adapted in the present building to more general uses" (686 F.2d at 1066). The Tax Court recognized in the instant case that its decision was inconsistent with the Fourth Circuit's decision in *A.C. Monk*, but it explained that it was not bound to follow that decision because appeal here lay to the Seventh Circuit (Pet. App. 103a n.29). The Seventh Circuit acknowledged below that, "[t]o the extent *Monk* disapproves of the *Scott Paper* percentage allocation method, we must reject the reasoning in *Monk*" (*id.* at 17a-18a). And the Seventh Circuit panel that decided this case, pursuant to local rules, circulated its opinion to all the active judges in the circuit "on the question of creating a conflict with *A.C. Monk*" (*id.* at 1a n.*). Thus, there can be little doubt that, if the instant case had arisen in the Fourth Circuit, respondent would not have been able to claim the investment tax credit based on 95% of the cost of its factory's electrical distribution system, but rather would have been entitled to a smaller credit as the Commissioner contended in his notice of deficiency.

2. Resolution of the existing circuit conflict is a matter of substantial administrative importance. The construction of a manufacturing facility is a major expense that often gives rise to the claim of an in-

vestment tax credit. Many companies engage in such major construction projects at one time or another. And almost every such construction project will involve electrical design or improvements, which will be used in substantial part to power machinery. If allowed to stand, therefore, the decision below can be expected to serve as the basis for claims of substantial investment tax credits by taxpayers throughout the Nation. We have been advised by the Internal Revenue Service that there are currently pending administratively and in the Tax Court more than 300 cases involving the computation of the investment credit for electrical systems of manufacturing facilities. The potential tax liabilities in those cases exceed $275 million.

In addition, the allocation rationale of the Seventh Circuit's decision may be susceptible of extension beyond the specific context of a factory electrical system. See, *e.g., Morrison, Inc.* v. *Commissioner*, 51 T.C.M. (CCH) 748 (1986) (extending *Scott Paper* to an electrical system of a cafeteria). It is reasonable to expect that this decision will be relied upon to argue for allocation to "section 38 property" of parts of the cost of other permanent installations (such as plumbing fixtures or retaining walls) that heretofore have been thought to be structural components of a building. Accordingly, unless the conflict in the circuits created by the decision below is resolved, a large number of investment credit cases can be expected to be decided in a manner that yields inconsistent treatment of different taxpayers with respect to what is often a very substantial item on their tax returns. Moreover, because we believe the decision below to be erroneous, those cases that fol-

low the decision below will result in a sizable windfall for taxpayers at the expense of the Treasury.[6]

3. Certiorari is also warranted because the court of appeals' decision expands the investment tax credit substantially beyond the boundaries that were intended by Congress. The Code provides a credit with respect to the taxpayer's investment in particular assets that constitute "section 38 property." The statutory definition of such property includes tangible personal property and "other tangible property * * * used as an integral part of manufacturing [or other specified] activities," but expressly excludes "a building and its structural components" (I.R.C. § 48(a)). This language makes it clear that the inquiry must focus on the *nature* of the specific asset, that is, whether the asset fits the definition of "sec-

[6] Under the 1986 tax reform proposal adopted by the Conference Committee, the investment tax credit would be repealed for assets placed in service on or after January 1, 1986. See H.R. 3838, 99th Cong., 2d Sess. § 211(a) (1986); Staff of the Joint Comm. on Taxation, 99th Cong., 2d Sess., *JCS-16, Summary of Conference Agreement on H.R. 3838 (Tax Reform Act of 1986)*, Tit. II.A.2, at 8 (Joint Comm. Print 1986). Even assuming that this repeal is enacted into law and that it entirely eliminates the investment tax credit for future years, we believe that certiorari is nevertheless warranted here. The number of pending and potential investment tax credit claims based on the decision below that remain open for pre-1986 investments and for other investments under transitional rules recommended by the Conference, coupled with the magnitude of the sums at stake in litigation over the credit, make the revenue consequences of this issue sufficiently substantial to justify the Court's attention. We note that the investment tax credit was repealed by Congress once before and then was restored less than two years later after economic conditions had changed. See Pub. L. No. 91-172, § 703(a), 83 Stat. 660; Pub. L. No. 92-178, § 101(b), 85 Stat. 498.

tion 38 property." As the Fourth Circuit stated in *A.C. Monk*, it does not accord with the statutory scheme (nor does it accord with common sense) for a discrete asset like a transformer or a wire to be "both a structural component and other property" (686 F.2d at 1065) or, more precisely, for 5% of a wire to be a structural component of a building whereas 95% of the same wire is not. Rather, an electrical system appropriate for the needs of most potential users of a building is reasonably viewed as a unit that is as much a "structural component" of the building as the walls and roof. Only where components of the electrical system are so "inextricably linked to the present, specific machinery" that they cannot "feasibly be adapted to uses other than the specific machinery [they were] designed to serve" can those components qualify for the investment tax credit under the plain terms of the statute. *A.C. Monk*, 686 F.2d at 1066.

The controlling Treasury Regulations track the statute's mandate to consider the nature of a particular asset in order to determine if it qualifies for the investment credit. Section 1.48-1(e)(2) of the Regulations defines "structural components" to include "such parts of a building as walls, partitions, floors, and ceilings * * *; windows and doors; all components * * * of a central air conditioning or heating system * * *; plumbing and plumbing fixtures * * *; *electric wiring* and lighting fixtures; * * * and other components relating to the operation or maintenance of a building" (emphasis added). The Regulation does recognize that there may be situations in which items that ordinarily would be viewed as structural components ought to be treated as "section 38 property" because they are uniquely tailored to the taxpayer's particular manufacturing

operation, such as equipment that is needed to preserve unusual temperature or humidity requirements. But the Regulation surely establishes a presumption that fixtures that are common to *all* manufacturing operations—such as electrical systems to supply power and plumbing systems to supply water—are "structural components" of the building unless the taxpayer can demonstrate an inextricable link between the fixtures and the particular machinery.

This plain and sensible reading of the Regulation is the one given to it by the Fourth Circuit in *A.C. Monk* and rejected by the Seventh Circuit here. Items that are ordinarily thought of as "structural components" of a building, such as electrical systems and heating equipment, do not qualify as "section 38 property" unless they are specifically tailored to the taxpayer's existing manufacturing operation and would be relatively valueless if the building were used in some other capacity. As the Fourth Circuit put it (686 F.2d at 1066), the question in commonsense terms is "whether a manufacturer converting the building to an alternate process would be able, with reasonable alterations, to use the existing system, or whether he would have essentially to scrap the system and install another."

The court of appeals below has turned the regulation on its head by holding that a standard electrical system, which would be easily adaptable to a different use by respondent or by any future tenant of the building, qualifies in large part for the investment credit simply because it now happens to be used to power respondent's existing machinery. The court has taken the Regulation's narrow exception for structural components that are unique to a particular manufacturing process and has expanded that ex-

ception to swallow the general rule that structural components are not qualifying property. This is an untenable interpretation of the Code that ignores the clear intent of Congress. Unless corrected, the decision below will yield substantial undeserved windfalls for taxpayers in many parts of the country.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Assistant Attorney General

ALBERT G. LAUBER, JR.
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

JONATHAN S. COHEN
WILLIAM A. WHITLEDGE
Attorneys

SEPTEMBER 1986

☆ U. S. GOVERNMENT PRINTING OFFICE; 1986 491507 20331